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C O N F I D E N T I A L SECTION 01 OF 02 REYKJAVIK 000263

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SUBJECT: ICELAND: CAN THIS COALITION BE SAVED?

Classified By: Amb. Carol van Voorst for reasons 1.4 (b) and (d).

11. (C/NF) Summary: Public support for Iceland's government has fallen below 50 percent in the wake of the financial crisis here, and cracks are beginning to widen between the two coalition parties as weekly demonstrations grow in size and fervor. PM Haarde's Independence Party (IP) has taken the brunt of criticism for the failed economy, while Foreign Minister Gisladottir's Social Democratic Alliance is polling higher than its election results last year. In the short term, a lack of viable (i.e., pro-EU) partners and Gisladottir's good relationship with Haarde will likely keep the FM from breaking up the coalition in the hope of new elections. However, Gisladottir has said publicly she is pushing within the cabinet for Iceland to explore EU membership, and polls show a majority of the public agree with her. Securing a \$6 billion package of IMF and bilateral financing will buy the government some time, but if Haarde cannot convince his party to go along with exploring EU membership we could see early elections called for the first time since the 1960s. Some form of reshuffle is almost inevitable, however -- Haarde will not be able to answer the growing pro-EU group in his party without lots of blood on the floor and the rousting of several old IP chieftans (including the Minister of Justice and Central Bank Chairman David Oddsson). End Summary.

12. (SBU) Following the economic disaster of October and the collapse of the country's banking sector, the government continues to take a beating in the polls. Public support for the government fell to 46 percent by the end of October, down 30 points from the beginning of the year. While support for the Social Democratic Alliance (the junior coalition partner) has held steady or increased slightly, Prime Minister Haarde's Independence Party (IP) has been hammered. The IP, after nearly two continuous decades as Iceland's largest political party, is now third behind the SDA and the opposition Left-Greens, pulling only 22 percent in the polls. The opposition parties and a growing portion of the electorate are now calling for elections before the current term ends in 2011. A poll at the end of October showed 60 percent support for early elections, and the Chairman of the Left-Greens showed up at the Embassy's Election Night event gleefully working the room with that encouraging datum. Demonstrations calling for -- among other things -- a new government continue to grow, with the latest protest on November 8 drawing over 3000 participants.

13. (C) That the public blames the IP specifically for the economic crisis is no coincidence -- the Prime Minister and Minister of Finance are both from the party, and the IP's 2007 campaign was based on the notion that only the Independence Party could be counted on to maintain Iceland's then-world-beating prosperity and quality of life. More significantly, many domestic and international observers blame former PM and Grand Old Man of the Independence Party David Oddsson for Iceland's stunning loss of credibility in the financial world. Oddsson has served as the highly controversial Chairman of the

Central Bank since 2005. He made a number of ill-considered statements to the media early in the crisis, and many suspect it was at least partially due to his wounded pride that Iceland did not immediately seek IMF assistance. Haarde's apparent inability to "control" or remove his predecessor as IP Chair has led many to blame the Independence Party for the continuing economic bad news.

14. (C/NF) Indeed, Haarde missed a key opportunity to gain political support by not replacing Oddsson early in the crisis. Even among IP stalwarts, Oddsson's standing has never been lower, with the party's younger, more business-oriented members asserting to Emboffs and journalists that it was time for Oddsson -- rabidly anti-EU membership for Iceland -- to finally exit the stage. Only Haarde has the authority to replace the Central Bank Chair, and speculation around town is that the PM has not pulled the trigger thus far out of a deep sense of personal loyalty to his old mentor. The result is that demonstrators now excoriate Haarde as well as Oddsson, the initial target of public ire. While Oddsson remains in the picture, it will be almost impossible for Haarde to start his party and his country moving towards the EU.

15. (C) Other IP members, however, are proving much more open to EU membership, and are finding support from those who previously stayed out of the debate. IP Vice Chair and Minister of Education Thorgerdur Katrin Gunnarsdottir, though cautioning that she was not making any sort of leadership challenge, said in a highly publicized late October interview that the her party had always pledged to take the most pragmatic stand on EU membership in terms of what was best for Iceland's interests. Given that both the global and domestic economic situation has changed so dramatically in recent months, Gunnarsdottir continued, it is only logical that the IP reexamine its stand. Bjarni Benediktsson, Chair of the Althingi Foreign Affairs

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Committee, quickly echoed this argument. PolOff has heard separately from IP sources that Benediktsson sees the party's old guard as standing in the way of not only serious consideration of EU membership for Iceland, but also Benediktsson's personal ambitions of a cabinet post.

16. (C/NF) Foreign Minister Gisladdottir's Social Democratic Alliance (SDA), however, has become increasingly strident in its calls for serious exploration of EU membership as well as the dismissal of Central Bank Chair Oddsson. Gisladdottir said in a press interview that she is pressing Haarde for a new policy on the EU, and other SDA ministers have been equally active on this front. However, to our knowledge, she has not made the leap to a push for early elections, though her party would be likely to benefit. There may be a practical explanation here, as Gisladdottir's recovery from brain surgery in September has kept her away from work for much of the tumultuous fall. Some here also credit her personal relationship with the Prime Minister as a brake on a move to change the coalition. The two party heads have developed an unexpectedly close and collaborative working relationship and clearly both like and respect each other. Gisladdottir may view Haarde as a useful ally in the future should she be able to convince him to reexamine the EU question.

17. (C/NF) Most probable, however, is the explanation that Gisladdottir simply does not see a viable alternative to the IP as a coalition partner at the moment. The Progressive Party -- Iceland's only other pro-EU party -- has seen only marginal gains over the last month, and would in all likelihood still be too small to form a two-party coalition with the SDA. The Liberal Party is even smaller, leaving only the Left-Green Movement. Although the Left-Greens have polled significantly higher of late, they still do not endorse EU membership for Iceland. Gisladdottir seems unwilling to go into coalition with yet another party that is against joining the EU. However, as with the IP, the Left-Greens are locked in an internal struggle over their EU policy; the party's Vice Chair told PolOff over the summer that she was sympathetic to the growing pro-EU wing of the party and that she expected a reevaluation of the party's EU policy by the end of 2008. This dynamic may be what FM Gisladdottir meant in an interview when she said early elections would be a distraction to the government now, "but then a new year is coming, and people will have to assess the situation then."

COMMENT

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18. (C/NF) In the short term, the Icelandic Government desperately needs to finalize the \$6 billion loan package with the IMF and other bilateral donors. If the IMF loan fails to come through, the government will lose what little remaining credibility it has on the economic front and may very well find it impossible to stay on. Despite the protests and the speculation around town, however, we note that there is little tradition here of disgraced politicians or governments -- even those convicted of crimes -- resigning from their posts. Early elections have not been invoked since the 1960s, and then only because a three-party coalition dissolved and no replacement could be created. No-confidence votes are virtually unheard of.

19. (C/NF) If the IMF loan comes through, a likely scenario is that after the new year SDA Chair Gisladdottir and a group led by IP Vice Chair Gunnarsdottir present the Prime Minister with their own ultimatums, both calling for a serious look at EU membership, and explicitly (SDA) or implicitly (IP) calling for Oddsson's removal. In any event, a cabinet reshuffle -- either to give the SDA more power over economic policymaking, to sweep out the IP old guard, or both -- seems inevitable once the fate of the IMF loan is clear.

van Voorst